Report

of the

Examination of

American Family Mutual Insurance Company

Madison, Wisconsin

As of December 31, 2001

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

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Jorge Gomez, *Commissioner*

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February 7, 2002

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Secretary, Southeastern Zone, NAIC
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Secretary, Western Zone, NAIC
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State of Connecticut
165 Market Street, 7th Floor
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Honorable Sally McCarty
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311 West Washington St., Suite 300
Indianapolis, Indiana 46204-2787

Honorable Jorge Gomez
Commissioner of Insurance
State of Wisconsin
121 East Wilson Street
Madison, WI 53702

Commissioners:

In accordance with your instructions, a compliance examination has been made of the affairs and financial condition of

AMERICAN FAMILY MUTUAL INSURANCE COMPANY
Madison, Wisconsin

and this report is respectfully submitted

I. INTRODUCTION

The previous examination of the company was conducted in 1997 as of December 31, 1996. The current examination covered the intervening period ending December 31, 2001, and included a review of such 2002 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

History
Management and Control
Corporate Records
Conflict of Interest
Fidelity Bonds and Other Insurance
Employees' Welfare and Pension Plans
Territory and Plan of Operations
Affiliated Companies
Growth of Company
Reinsurance
Financial Statements
Accounts and Records
Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

Independent Actuary's Review

Independent actuaries were engaged under a contract with the Office of the Commissioner of Insurance. They reviewed the adequacy of the company's loss reserves and loss adjustment expense reserves. The results of their work were reported to the examiner-in-charge. As deemed appropriate, reference is made in this report to the actuaries' conclusion.

II HISTORY AND PLAN OF OPERATION

American Family Mutual Insurance Company (AFMIC) is a mutual property and casualty insurer, organized in 1927 under the provisions of ch. 611, Wis. Stat., as the Farmers' Mutual Automobile Insurance Company. The current name was adopted in 1963. The company is currently licensed in twenty-two states; North and South Carolina were added during 2002. In 2001 the company began writing business in Nevada. For 2001 AFMIC wrote direct premium in the following states:

Wisconsin	$684,817,439	19.5%
Missouri	583,657,617	16.6
Minnesota	439,454,341	12.5
Illinois	387,389,949	11.0
Colorado	330,635,320	9.4
All others	1,089,950,784	31.0
	$3,515,905,450	100.0%

The company is licensed in the following states:

Arizona	Colorado	Idaho
Illinois	Indiana	Iowa
Kansas	Minnesota	Missouri
Montana	Nebraska	Nevada
New Mexico	North Carolina	North Dakota
Ohio	Oregon	South Carolina
South Dakota	Utah	Washington
Wisconsin		

The major products marketed by the company include private passenger auto, auto physical damage, and homeowners; accounting for 83% of direct premium written. The major products are marketed through a captive agency force of 3,802 full time and 77 part time agents, as of September 30, 2002.

The following table is a summary of the net insurance premiums written by the company in 2001. The growth of the company is discussed in the Financial Data section of this report.

Line of Business	**Direct Premium**	**Reinsurance Assumed**	**Reinsurance Ceded**	**Net Premium**
Fire	$ 11,390,404	$ 1,964,147	$ 173,058	$ 13,181,493
Allied lines	14,235,780	81,236	6,559,403	7,757,613
Farmowners multiple peril	62,597,435		676,695	61,920,740
Homeowners multiple peril	818,132,976	15,685,505	8,781,340	825,037,141
Commercial multiple peril	180,181,582	4,160,051	1,600,365	182,741,268
Inland marine	1,269,095	26,636	20,509	1,275,222
Earthquake	5,711,909	55,846	92,077	5,675,678
Group accident and health	11,275,240			11,275,240
Other accident and health	200,760,348	1,944,826	250,332	202,454,842
Workers' compensation	51,945,625	909,024	(755,681)	53,610,330
Other liability - occurrence	37,733,888	583,648	691,476	37,626,060
Other liability - claims made	2,585,598		874	2,584,724
Products liability - occurrence	95,818	380		96,198
Private passenger auto liability	1,048,525,892	370,943,607	471,613	1,418,997,886
Commercial auto liability	21,976,075	809,142	8,005	22,777,212
Auto physical damage	1,047,452,524	232,610,147	6,274,992	1,273,787,679
Fidelity	31,875	1,182	10	33,047
Burglary and theft	3,385	55	1	3,439
Reinsurance—non-proportional assumed property		(70)		(70)
Reinsurance—non-proportional assumed liability		1,605		1,605
Total All Lines	$3,515,905,449	$629,776,967	$24,845,069	$4,120,837,347

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of twelve members, nine of whom are outside directors. Directors are grouped into three groups of four. One group is elected annually with each Director serving for three years. Officers are elected at the board's annual meeting. The outside board members currently receive $24,000 a year as a retainer and $1,500 per meeting attended for serving on the board.

Currently the board of directors consists of the following persons:

Name and Residence	Principal Occupation	Term Expires
David Anderson Madison, Wisconsin	President and Chief Operating Officer American Family Group	2003
Ted Kellner Milwaukee, Wisconsin	Chairman and Chief Executive Officer Fiduciary Management, Inc.	2004
Dale Mathwich Madison, Wisconsin	Chairman and Chief Executive Officer American Family Group - Retired	2005
Thomas Mohs Madison, Wisconsin	Chairman, Placon	2004
Walter Oliver Falls Church, VA.	Vice President, Human Resources And Administration - General Dynamics	2005
Barbara Parish Watertown, WI	President, Wis-Pak, Inc.	2004
Harvey Pierce Madison, Wisconsin	Chairman and Chief Executive Officer American Family Group	2004
Eliot Protsch Cedar Rapids, Iowa	President of Alliant/IES Utilities	2005
Richard Renk Sun Prairie, Wisconsin	Chairman, Wm F. Renk and Sons	2005
Beverly Simone Madison, Wisconsin	President and Chief Operation Officer Madison Area Technical College	2003
John Wiley Madison, Wisconsin	Chancellor, University of Wisconsin-Madison	2003
Thomas Zimbrick Madison, Wisconsin	Chairman and Chief Executive Officer Zimbrick, Inc.	2003

Officers of the Company

The officers serving at the time of this examination are as follows:

Name	Office	2001 Compensation
Harvey Pierce	Chairman of the Board and Chief Executive Officer	$1,439,020
David Anderson	President and Chief Operating Officer	836,786
Daniel R. DeSalvo	Executive Vice President – Sales	453,097
James Eldridge	Executive Vice President – Legal; Secretary	464,364
John B. Johnson	Executive Vice President – Finance, Treasurer	548,041
Darnell Moore	Executive Vice President – Administration	447,055
Mark V. Afable	Vice President – Government Affairs/Compliance	221,516
Donald Alfermann	Vice President – Sales, Mountain Region	291,186
Jeffrey E. Burke	Vice President – Sales, Northwest Region	169,611
Byrne Chapman	Vice President – Information Services	339,316
Vicki L. Chvala	Vice President – Human Resources	290,309
Michael R. Duran	Vice President – Sales, Midland Region	193,193
Richard A. Fetherston	Vice President – Public Relations	216,781
Bradley J. Gleason	Vice President – Actuarial	277,173
Richard J. Haas	Vice President – Office Administration	263,543
Nancy M. Johnson	Vice President – Education	216,767
Ralph Kaye	Vice President – Sales- Valley Region	256,377
Thomas King	Vice President – Investments	407,102
David Krueger	Vice President – Sales, Great Lakes Region	318,071
Alan E. Meyer	Vice President – Marketing	277,085
Jerome G. Rekowski	Vice President – Commercial Lines	217,115
Jack C. Salzwedel	Vice President – Personal Lines	237,478
Daniel R. Schultz	Vice President – Controller	267,874
Christopher Spencer	Vice President – Legal	244,290
Terese Ann Taarud	Vice President –Claims	265,833
Joseph Tisserand	Vice President – Life/Health	405,380
James W. Behrens	Assistant Secretary	150,016
William J. Smith	Assistant Treasurer	127,678

Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination are listed below.

Executive Committee
Harvey R. Pierce, Chair
David R. Anderson
Ted D. Kellner
Dale F. Mathwich
Walter M. Oliver
Richard R. Renk

Finance Committee
Harvey R. Pierce, Chair
David R. Anderson
John Brent Johnson
Ted D. Kellner
Dale F. Mathwich
Walter M. Oliver
Richard R. Renk

Audit Committee
Elliot G.. Protsch, Chair
Thomas J. Mohs
Barbara A. Parish
Beverly S. Simone
John D. Wiley
Thomas J. Zimbrick

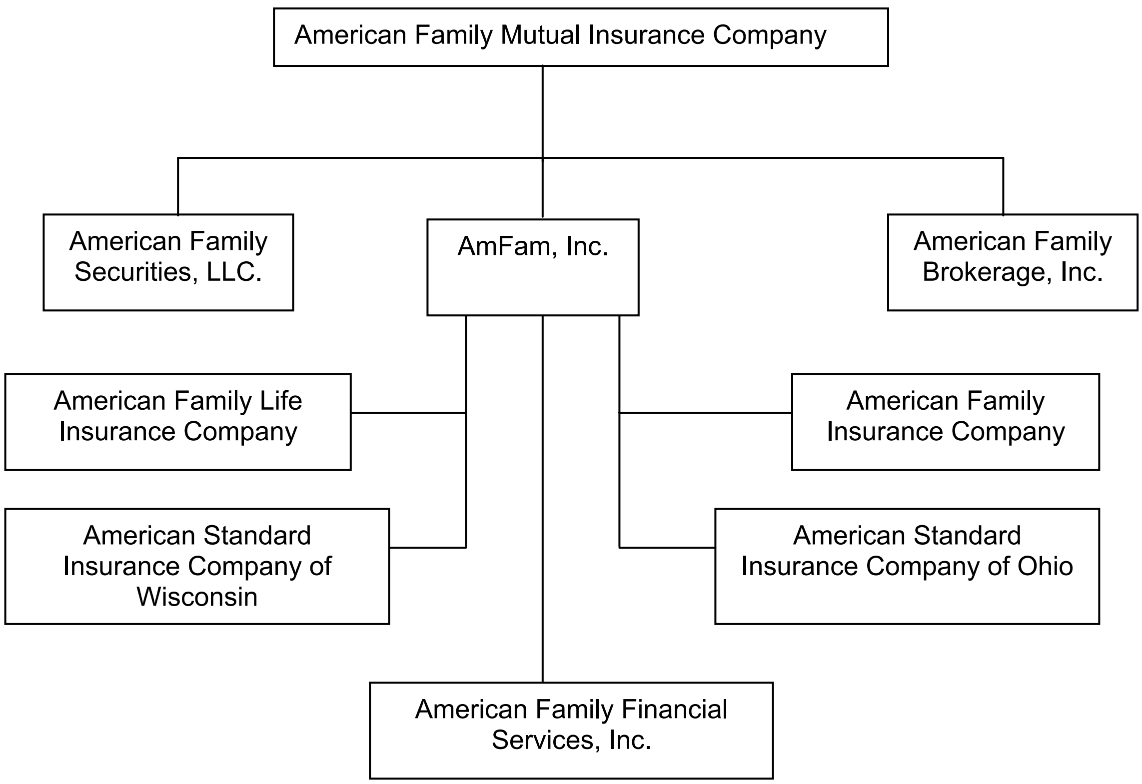
Officer Compensation Committee
Walter M. Oliver, Chair
David R. Anderson
Barbara A. Parish
Harvey R. Pierce
Beverly S. Simone
Thomas J. Zimbrick

Nominating Committee
Harvey R. Pierce Chair
David R. Anderson
Thomas J. Mohs
Eliot G. Protsch
Beverly S. Simone
John D. Wiley

IV. AFFILIATED COMPANIES

American Family Mutual Insurance Company (AFMIC) is the parent of a holding company system referred to as the "American Family Insurance Group." The organizational chart below depicts the relationships among the affiliates in the group. A brief description of the affiliates of AFMIC follows the organizational chart.

Organizational Chart
As of December 31, 2001



AmFam, Inc.

AmFam, Inc., was incorporated in 1981 to serve as a downstream holding company for the American Family Insurance Group. As of December 31, 2001, the company's consolidated GAAP-basis audited financial statement reported assets of $4.2 billion, liabilities of $3.3 billion and stockholder's equity of $900 million. Of that amount, all but approximately $241,000 was derived from the value of subsidiaries.

American Family Brokerage, Inc.

American Family Brokerage, Inc., was incorporated in 1985 as an insurance agency and operates within the same states as its parent AFMIC. Its primary objective is to assist American Family agents in securing coverage for their clients when the coverage or limits are not available through the American Family Insurance Group. As of December 31, 2001, the company's GAAP basis audited financial statement reported assets of $1.504 million, liabilities of $1.339 million, and stockholder's equity of $165,000. Operations for 2001 produced a net income of $192,000.

American Family Securities, LLC

American Family Securities, LLC (AFS), was incorporated on July 14, 2000, with a capital contribution of $250,000 from AFMIC, as a limited liability company whose sole member is AFMIC. AFFS, a non-clearing, registered broker dealer, is the principal underwriter for American Family Life Insurance Company's new variable life and annuity products. On March 23, 2001, AFS was admitted into the National Association of Securities Dealers (NASD) to sell AFLIC's variable products. As of December 31, 2001, the company's GAAP basis audited financial statement reported member's equity of $264,000. Operations for 2001 produced a net income of $11,000.

American Family Financial Services, Inc.

American Family Financial Services, Inc. (AFFS), was acquired by American Family Insurance Group in 1969, to provide direct loans and leases, primarily to policyholders. It offers these products through AFMIC's multi-line, exclusive agency force in twenty-two states. As of December 31, 2001, the company's GAAP basis audited financial statement reported assets of $202 million, liabilities of $180 million, and stockholder's equity of $22.7 million. Operations for 2001 produced a net income of $721,000.

AFFS finances its loan portfolio primarily through the sale of commercial paper. AFMIC has agreed to guarantee the debt of AFFS, in order to allow the company to receive the best possible interest rates. In 1998 the Board of Directors of AFMIC authorized an increase in the guarantee limit to $375 million. As of December 31, 2001, AFFS outstanding guaranteed debt totaled $92 million. In addition, both AFMIC and AFLIC lend AFFS additional funds through the use of short-term notes. At December 31, 2001, there were no outstanding short-term notes issued by AFFS owed to an affiliate.

American Standard Insurance Company of Ohio

American Standard Insurance Company of Ohio (ASICO) was incorporated in 1995 and writes business only in Ohio. ASICO was founded for the purposes of operating efficiencies and state tax savings. ASICO writes lines of business identical to ASIC's and cedes 100% of these direct writitngs to AFMIC. Insurance is sold through AFMIC's agents. As of December 31, 2001, ASICO reported assets of $25.8 million, liabilities of $21.6 million and policyholders' surplus of $4.2 million. Operations for 2001 produced a net income of approximately $425,000.

American Family Insurance Company

American Family Insurance Company (AFIC) was incorporated in Ohio in 1995 and writes business only in that state. AFIC was founded for the purposes of operating efficiencies and state tax savings. AFIC cedes 100% of its direct writings to AFMIC. AFIC writes lines of business identical to American Family Mutual Insurance Company and markets through AFMIC's agents. As of December 31, 2001, AFIC reported assets of $59.7 million, liabilities of $52 million and policyholders' surplus of $7.7million. Operations for 2001 produced net income of approximately $663,000.

American Family Life Insurance Company

American Family Life Insurance Company (AFLIC) was incorporated in 1957. The company is currently licensed in 23 states, and writes primarily ordinary life insurance, including traditional and universal life products. During 2001 the company obtained authorization to start writing variable products; life and annuities. As of December 31, 2001, AFLIC reported assets of $2.7 billion, liabilities of $2.4 billion (both amounts include $3.5 million from separate accounts), and surplus of $243 million. AFLIC was examined concurrently with the AFMIC examination. The results of the examination are described within a separate report.

American Standard Insurance Company of Wisconsin

American Standard Insurance Company of Wisconsin (ASIC) was incorporated in 1961. The company is currently licensed in 22 states, and is limited to providing insurance for motorcycles and for marginal and substandard private passenger automobile risks. ASIC's direct writings are 100% ceded to AFMIC. As of December 31, 2001, ASIC reported assets of $274 million, liabilities of $92 million, and capital and surplus of $182 million. ASIC was examined concurrently with the AFMIC examination. The results of the examination are described within a separate report.

Affiliated Agreements

In 1995, AFMIC developed an inter-company cost allocation agreement for the reimbursement of expenses paid by AFMIC on behalf of its affiliates. Allocated cost is based on the actual cost of providing the service multiplied by the affiliate's proportionate share of the benefit conferred. Refer to the "Summary of Examination Results" section of this report for further discussion on this topic.

Effective April 29, 2002, AFMIC and affiliates entered into a restated tax allocation agreement for the purpose of filing federal income tax returns on a consolidated basis. The tax liability of the group is allocated to individual member companies in accordance with Internal Revenue Service regulations. Each participating affiliate reimburses AFMIC for payment of the affiliate's portion of liability included in the consolidated tax liability, and each respective affiliate receives its pro-rata share of consolidation-basis tax benefits.

V. REINSURANCE

The company's reinsurance program consists primarily of assuming premium from affiliated companies and ceding catastrophe excess coverage through pooling arrangements with unaffiliated foreign and to a lesser degree U.S. reinsurance companies. A summary of the current significant reinsurance contracts and strategy is below. All contracts contained proper insolvency provisions.

Reinsurance Assumed

Assumed business is primarily intercompany reinsurance. As noted in the "Affiliated Companies" section, AFMIC assumes 100% of the direct writings of ASIC, AFIC, and ASICO. These arrangements are represented by signed contracts, which include all necessary provisions. In 2001, this business represents 16% of AFMIC's gross written premium. These writings are primarily personal and automobile lines of business. Mandatory pools and other 2001 nonaffiliated reinsurance assumptions represent less than 0.1% of gross written premium.

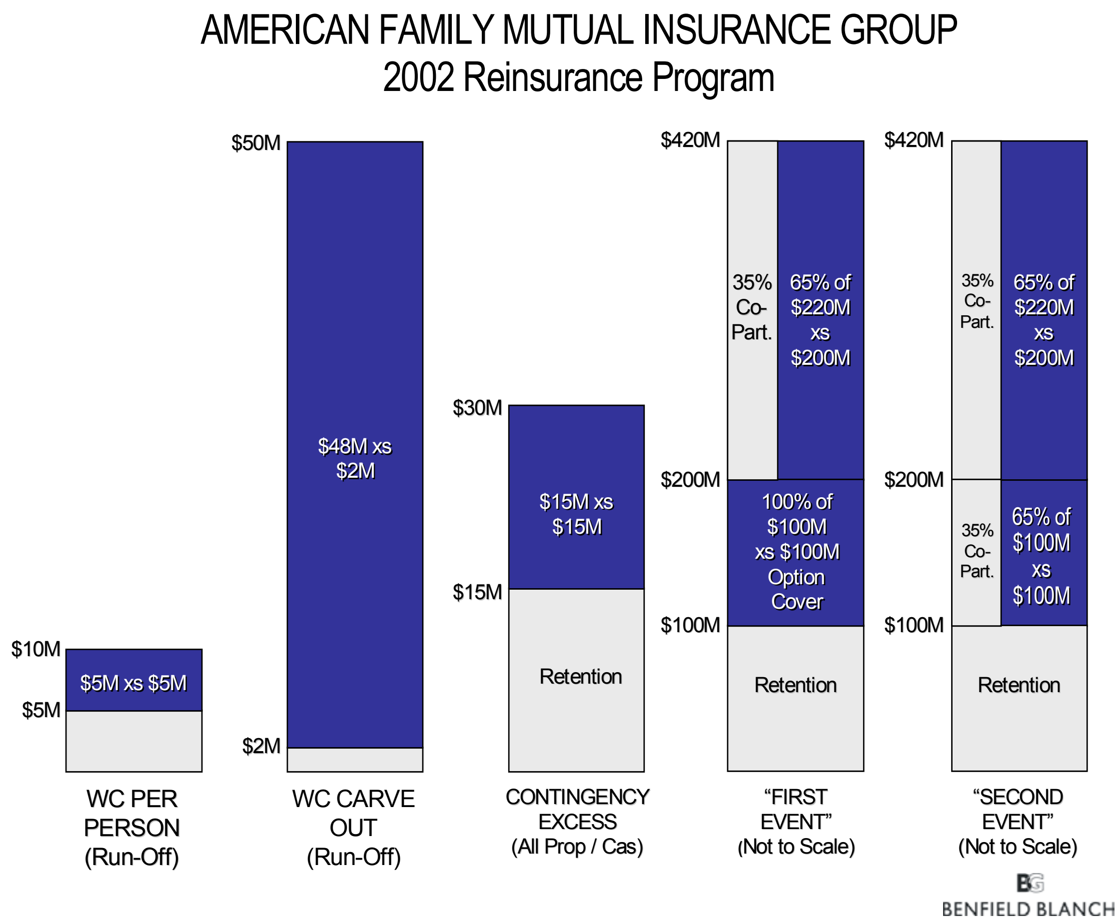
Reinsurance Ceded

AFMIC historically has ceded a relatively small amount of business, and that trend continued during the period under examination. In 2001, AFMIC ceded less than 1% of gross written premium.

In most years, AFMIC has retained $200 million per catastrophic event, and generally the catastrophe reinsurance is purchased for one calendar year. For 2002 coverage, however, the company had purchased an option in late 2000 (in conjunction with its 2001 reinsurance program), that would allow the company to pay a specified premium for $100 million coverage in excess of $100 million retention for one event, only if during 2001 the company incurred a catastrophic loss in excess of $200 million. During 2001, the company did incur such an event (a hailstorm in the St. Louis area) and the company did pay to exercise its option for this 2002 contract. The company purchased another reinsurance contract to cover $100 million excess of $100 million retention for a second event, which was 65% subscribed.

The company also purchased $220 million coverage in excess of $200 million retention, which was 65% subscribed.

AFMIC also purchased contingency reinsurance coverage of $15 million in excess of $15 million retention. This coverage is for unusual circumstances, such as a hypothetical 100-car accident due to fog that involved numerous AFMIC policyholders. The following is a chart depicting the 2002 Reinsurance Program.



The 2001 Reinsurance Program differed from the 2002 program in the following manner: 1) There was an additional layer of contingency excess, for $7.5 million in excess of $7.5 million. 2) There was no option contract. 3) For the second catastrophe event the company's retention dropped down to $50 million. 4) Company participation was 5% for catastrophe coverage

All coverage is placed through E. W. Blanch Company, a reinsurance intermediary. The examination found that the company has entered into a reinsurance intermediary agreement that contains all provisions required under s. Ins 47, Wis. Adm. Code.

A review of the reinsurers participating under these agreements indicated that some of the major reinsurers were not licensed to do business in Wisconsin. The examiners found that the company adequately reviews security rankings of its reinsurers and obtained letters of credit where required.

VI. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported in the December 31, 2001, annual statement to the Commissioner of Insurance. Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

American Family Mutual Insurance Company
Assets
As of December 31, 2001

	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	$2,923,293,967	$	$2,923,293,967
Stocks:			
Common stocks	2,319,199,760		2,319,199,760
Real estate:			
Occupied by the company	242,871,468		242,871,468
Properties held for the production of income	11,592,950		11,592,950
Properties held for sale	2,596,990		2,596,990
Cash	25,368,732		25,368,732
Short-term investments	133,764,195		133,764,195
Other invested assets	149,398,743	82,346	149,316,397
Receivable for securities	7,201,107		7,201,107
Agents' balances or uncollected premiums:			
Premiums and agents' balances in course of collection	41,443,350	14,327,613	27,115,737
Premiums, agents' balances, and installments booked but deferred and not yet due	599,392,827	(11,943)	599,404,770
Reinsurance recoverable on loss and adjustment payments	18,073,878		18,073,878
Federal and foreign income tax recoverable and interest there on	145,990,772		145,990,772
Guaranty funds receivable or on deposit	17,000,175	7,222,296	9,777,879
Electronic data processing equipment and software	43,622,013		43,622,013
Interest, dividends, and real estate income due and accrued	44,603,906		44,603,906
Receivable from parent, subsidiaries, and affiliates	143,918,562		143,918,562
Other assets nonadmitted:			
Furniture, equipment, and supplies	43,138,379	43,138,379	
Leasehold improvements	1,684,302	1,684,302	
Write-ins for other than invested assets			
Cash items	680,614	680,614	
Advances		634,677	
Reinsurance receivable		955,367	
Pension asset	1,073,145	1,073,145	
Miscellaneous receivables	171,335		171,335
Total Assets	$6,917,671,214	$68,831,429	$6,848,839,785

American Family Mutual Insurance Company
Liabilities, Surplus, and Other Funds
As of December 31, 2001

Losses	$1,585,483,084
Loss adjustment expenses	449,850,652
Commissions payable, contingent commissions, and other similar charges	10,000,000
Other expenses (excluding taxes, licenses, and fees)	397,903,062
Taxes, licenses, and fees (excluding federal and foreign income taxes)	301,153
Federal and foreign income taxes	20,308,465
Unearned premiums	1,425,174,066
Dividends declared and unpaid:	
Policyholders	1,457,816
Ceded reinsurance premiums payable (net of ceding commissions)	(26,130)
Amounts withheld or retained by company for account of others	14,504,898
Remittances and items not allocated	38,936,692
Provision for reinsurance	32,506
Drafts outstanding	115,541,946
Payable to parent, subsidiaries, and affiliates	113,729,442
Write-ins for liabilities:	
All other liabilities	20,178,544
Capital contributions payable	54,681,878
Premium rebate	1,247
Total Liabilities	4,248,059,321
Write-ins for special surplus funds:	
Non-assessable guaranty fund	
Unassigned funds (surplus)	1,250,000
	2,599,530,464
Surplus as Regards Policyholders	2,600,780,464
Total Liabilities and Surplus	$ 6,848,839,785

American Family Mutual Insurance Company
Summary of Operations
For the Year 2001

Underwriting Income	
Premiums earned	$3,996,598,808
Deductions:	
Losses incurred	3,146,893,740
Loss expenses incurred	512,679,357
Other underwriting expenses incurred	938,772,030
Total underwriting deductions	4,598,345,127
Net underwriting (loss)	(601,746,319)
Investment Income	
Net investment income earned	185,556,224
Net realized capital gains	392,784,072
Net investment gain	578,340,296
Other Income	
Net (loss) from agents' or premium balances charged off	(122,860)
Finance and service charges not included in premiums	46,823,215
Write-ins for miscellaneous income:	
Net gain on sale of equipment	(90,453)
Net billing plan write-offs	(19,760,503)
Other income	3,563,882
Total other income	30,413,281
Net income before dividends to policyholders and before federal and foreign income taxes	7,007,258
Dividends to policyholders	1,664,047
Net income after dividends to policyholders but before federal and foreign income taxes	5,343,211
Federal and foreign income taxes incurred	(5,961,473)
Net Income	$ 11,304,684

American Family Mutual Insurance Company
Cash Flow
As of December 31, 2001

Premiums collected net of reinsurance	$4,063,504,385		
Loss and loss adjustment expenses paid (net of salvage or subrogation)	3,540,432,918		
Underwriting expenses paid	891,712,942		
Cash from underwriting		$(368,641,475)	
Investment income (net of investment expense)		189,427,960	
Other income (expenses):			
Agents' balances charged off	(122,860)		
Write-ins for miscellaneous items:			
Finance and service charges not included in premiums	46,823,214		
Net gain on sale of equipment	(90,453)		
Net billing plan write-offs	(19,760,503)		
Other income	3,563,882		
Total other income		30,413,280	
Deduct:			
Dividends to policyholders paid		1,645,500	
Federal income taxes paid (recovered)		13,737,750	
Net cash from operations			$(164,183,485)
Proceeds from investments sold, matured, or repaid:			
Bonds	262,887,071		
Stocks	1,106,537,501		
Real estate	311,393		
Other invested assets	8,071,039		
Miscellaneous proceeds	108,044,455		
Total investment proceeds		1,485,851,459	
Cost of investments acquired (long-term only):			
Bonds	267,566,108		
Stocks	1,032,003,510		
Real estate	17,164,440		
Other invested assets	51,925,645		
Total investments acquired		1,368,659,703	
Net cash from investments			117,191,756
Cash provided from financing and miscellaneous sources:			
Net transfers from affiliates	18,914,510		
Other cash provided	52,197,514		
Total		71,112,024	
Cash applied for financing and miscellaneous uses:			
Other applications		12,569,075	
Net cash from financing and miscellaneous sources			58,542,949
Net change in cash and short-term investments			11,551,220

Reconciliation

Cash and short-term investments, December 31, 2000	147,581,706
Cash and short-term investments, December 31, 2001	$159,132,926

American Family Mutual Insurance Company
Compulsory and Security Surplus Calculation
December 31, 2001 (in 000s)

Assets		$6,848,840	
Less security surplus of insurance subsidiaries		76,690	
Less liabilities		4,248,059	
Adjusted surplus			$2,524,090
Annual premium:			
Individual accident and health	$ 202,455		
Factor	15%		
Total		30,368	
Group accident and health	11,275		
Factor	10%		
Total		1,128	
All other insurance	3,907,107		
Factor	20%		
Total		781,421	
Compulsory surplus			812,917
Compulsory surplus excess (or deficit)			$1,711,173
Adjusted surplus (from above)			$2,524,090
Security surplus: (factor of 110%)			894,209
Security surplus excess (or deficit)			$1,629,881

American Family Mutual Insurance Company
Reconciliation and Analysis of Surplus
For the Five-Year Period Ending December 31, 2001

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	1997	1998	1999	2000	2001
Surplus, beginning of year	$2,150,921,987	$2,642,495,095	$2,809,297,877	$3,138,681,728	$2,906,073,586
Net income	184,121,748	12,306,098	213,646,873	144,256,810	11,304,684
Net unrealized capital gains or (losses)	311,834,258	169,676,400	95,252,721	(366,039,717)	(247,532,342)
Change in net deferred income tax					30,790,735
Change in non-admitted assets	1,925,102	(3,020,276)	(4,291,155)	(14,732,770)	(3,203,018)
Change in provision for reinsurance					(32,506)
Cumulative effect of changes in accounting principles					(96,845,396)
Write-ins for gains and (losses) in surplus:					
FAS 87 pension			(733,028)	(1,287,465)	224,720
Change in excess of statutory reserves over statement reserves	(9,908,000)	(11,459,440)	25,508,440	5,195,000	
Extraordinary amounts of taxes for prior years	3,600,000	(700,000)			
Surplus, end of year	$2,642,495,095	$2,809,297,877	$3,138,681,728	$2,906,073,586	$2,600,780,463

American Family Mutual Insurance Company
Insurance Regulatory Information System
For the Five-Year Period Ending December 31, 2001

The following is a summary of NAIC Insurance Regulatory Information System (IRIS) results for the period under examination. Exceptional ratios are denoted with asterisks. A discussion of the exceptional ratios may be found after the IRIS ratios

	Ratio	1997	1998	1999	2000	2001
#1	Gross Premium to Surplus	115.0%	119.0%	114.0%	130.0%	159.0%
#2	Net Premium to Surplus	115.0	118.0	114.0	130.0	158.0
#3	Change in Net Writings	9.0	9.0	8.0	5.0	9.0
#4	Surplus Aid to Surplus	0.0	0.0	0.0	0.0	0.0
#5	Two-Year Overall Operating Ratio	97.0	99.0	101.0*	101.0*	106.0*
#6	Investment Yield	3.9*	3.4*	3.2*	3.0*	3.2*
#7	Change in Surplus	22.0	7.0	12.0	-6.0	-9.0
#8	Liabilities to Liquid Assets	58.0	58.0	58.0	63.0	71.0
#9	Agents' Balances to Surplus	0.0	0.0	0.0	1.0	1.0
#10	One-Year Reserve Devel. to Surplus	-5.0	-2.0	0.0	-4.0	1.0
#11	Two-Year Reserve Devel. to Surplus	-9.0	-6.0	-2.0	-1.0	-1.0
#12	Estimated Current Reserve Def. To Surplus	2.0	5.0	0.0	-8.0	4.0

Ratio No. 5 measures the company's profitability over the previous two-year period. Unusual values are over 100. The exceptional results in 1999, 2000 and 2001 were due to some unusually severe storms resulting in numerous claims in 1998, 2000, and 2001. Ratio No. 6, investment yield, is net income as a percentage of the average amount of cash and invested assets during the year. Unusual values are over 10 or under 4.5. The exceptional results for all years under examination were due to a combination of factors. One of the major contributing factors was that tax exempt bonds were between 80 and 85% of AFMIC's bond portfolio, which have lower yields than taxable bonds. Second, the company's investment in common stock provides a low cash yield (under 1%), the company invests in unaffiliated common stock looking more for capital gains rather than dividend income. Third, there was a substantial increase in real estate investments to build a new corporate headquarters, which provides a cash yield of 4-5%.

Growth of American Family Mutual Insurance Company

Year	Admitted Assets	Liabilities	Surplus As Regards Policyholders	Net Income
1997	$5,544,605,805	$2,902,110,710	$2,642,495,095	$184,121,748
1998	5,886,497,655	3,077,199,778	2,809,297,877	12,306,098
1999	6,503,194,123	3,364,512,395	3,138,681,728	213,646,873
2000	6,712,845,931	3,806,772,343	2,906,073,588	144,256,810
2001	6,848,839,785	4,248,059,321	2,600,780,464	11,304,684

Year	Gross Premium Written	Net Premium Written	Premium Earned	Loss And LAE Ratio	Expense Ratio	Combined Ratio
1997	$3,047,713,866	$3,035,293,181	$2,941,305,061	78.7%	22.0%	100.7%
1998	3,337,834,715	3,321,842,698	3,219,712,096	85.9	22.4	108.3
1999	3,592,260,817	3,575,776,956	3,444,642,463	81.7	22.5	104.2
2000	3,784,480,733	3,768,853,535	3,677,894,511	86.5	22.3	108.8
2001	4,145,682,416	4,120,837,347	3,996,598,808	91.6	22.0	113.6

The company reported heavy storm related losses in 1998 an increase of 22% from 1997 In 2001 the company reported catastrophe losses of $835 million, of which $200 million was covered by reinsurance; compared to similar losses of $472 million in 2000. The increases in incurred claims and loss adjusting expense resulting from the heavy storms also increased loss and LAE ratios, combined ratios, and significantly reduced net income for those two years. Net income for 1998 was a decrease of 93% from 1997, and net income in 2001 was down 92% from 2000. The company also reported incurring heavier than usual storm losses in 2000. The decrease in surplus during 2000 and 2001 is also due in a large part to the decrease in the value of the company's common stock investments, resulting from the general decrease in stock markets during this period, and which continued during 2002.

Reconciliation of Surplus per Examination

The examination made no adjustments to the company's reported surplus as regards policyholders and no reclassifications of any balance sheet items.

VII. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

There were three specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Securities Reconciliations—It is recommended that the company develop procedures to reconcile its records to custodial records, for securities not paying interest or dividends.

   Action—Compliance

2. Premiums in Course of Collection, Reporting—It is recommended that the company develop an approach to properly shift deferred premium to “premiums in course of collection" when these receivables meet their due dates.

   Action—Compliance

3. Premiums in Course of Collection, Documentation—It is recommended that the company review its systems documentation procedures, to ensure that the new EDP systems are designed to comply with s. Ins. 6.80, Wis. Adm. Code.

   Action–Compliance

Summary of Current Examination Results

Management and Control

The company has established a procedure for disclosure of conflicts of interest for its officers, directors, and responsible employees in compliance with a directive of the Commissioner of Insurance. As part of the examination a review was performed to insure that all officers and directors are complying with the company's conflict of interest disclosure requirements. This review noted that one officer had not completed this disclosure for any of the years under examination, contrary to company policy. During examination fieldwork, this officer was required to and did complete AFMIC's conflict of interest disclosure questionnaire for the years 1997 to 2002. It is recommended that the company continue to maintain compliance with its conflict of interest disclosure requirements for its Board of Directors, officers and designated employees.

As referenced in the Management and Control section of this report, John Brent Johnson is a member of the board appointed Finance Committee. According to s. 611.56 (1), Wis. Stat., "the board may designate one or more committees, each consisting of 3 or more directors." However, Mr. Johnson is the only member of the committee that is not a member of the board. It is recommended that the company comply with s. 611.56 (1), Wis. Stat. and appoint only directors as members of board appointed committees.

Financial Reporting – Schedule Y

During the review of affiliated agreements it was noted that the company was not reporting any amounts on Schedule Y, Part 2, Column 8 - Management Agreements and Service Contracts. However, as discussed in the "Affiliated Agreements" section of this report, AFMIC is reimbursed for the costs of providing services for the group and for any federal taxes associated with filing on a consolidated basis.

NAIC Annual Statement Instructions – Property and Casualty provide that in Schedule Y, Part 2, an insurer shall report all revenues and expenditures under intercompany contracts for services provided by the insurer, including income tax amounts resulting from tax-sharing agreements, from other affiliates subject to a materiality test. However, under s. Ins 40.03 (5), Wis. Adm. Code, "any transaction related to a management, exclusive agency or similar agreement or which is a service contract or cost-sharing arrangement is a material transaction." It is recommended that the company report in Schedule Y of its statutory annual statements all transactions among affiliates relating to the cost-sharing and income tax allocation agreements in compliance with s. Ins 40.03 (5), Wis. Adm. Code.

Subsequent to examination fieldwork the company has reported transactions between affiliates in the 2002 Schedule Y, Part 2 under Management Agreements and Service Contracts.

Invested Assets

AFMIC entered into a custodial agreement, effective January 1, 1983, with First Wisconsin National Bank on behalf of American Family Group for the safekeeping of most of the groups securities. The examiners' review of this custodian agreement indicated that it did not contain the following clause, as recommended by the NAIC in the Financial Condition Examiners Handbook:

> If there is a loss of securities for which the custodian is obligated to indemnify the company, either the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

Also, the clause in the agreement about indemnification by the custodian did not contain all of the NAIC recommended language as included below:

> The custodian is obligated to indemnify the insurance company for any loss of securities of the insurance company in the custodian's custody occasioned by the negligence or dishonesty of the custodian's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction.

The review also noted that the agreement had not been updated since inception in 1983. During that time the name of the custodial bank had changed from First Wisconsin to Firstar and then recently to U. S. Bank, which bought Firstar. Also the agreement mentions Midwest Securities Trust Company (MSTC) as a limited purpose trust company. The agreement states that certain securities are to be deposited in MSTC's non-proprietary account. References to MSTC are no longer valid as AFMIC now uses Depository Trust Company. It is recommended that the company amend the custodial agreement to include the language recommended by the NAIC's Financial Condition Examiners Handbook, to replace references to Midwest Securities with the current trust company, and to replace the custodian with the current one.

During fieldwork the company began meeting with U.S. Bank officials about changing the custodial agreement to address the issues raised in this report, among other changes desired by the company.

Remittances and Items not Allocated

The examiner's review of Remittances and Items not Allocated noted that the balance contained advance premium payments, i.e., policyholder payments made before year-end 2001 for policies with effective dates in 2002. Advance premiums should have been recorded as a write-in liability in 2001 (and should be on the pre-printed line for Advance premiums in 2002 and subsequent years). Advance premiums do not meet the definition of Remittances and Items not Allocated in SSAP 67. Further discussion on advance premiums is below under Advance Premium Accounting. It is recommended that the company comply with the NAIC's Accounting Practices and Procedures Manual SSAP 67 and the NAIC's Annual Statement Instructions – Property and Casualty for the reporting of Remittances and Items not Allocated.

Subsequent to fieldwork, the company filed its 2002 annual statement with the Commissioner's office. A review of that statement indicated that the company had reported advance premium on the appropriate line.

Amounts Withheld or Retained by Company for Account of Others

The examiner's review of this account noted that it contained cash receipts that were being held in suspense accounts until proper allocation could be determined. According to the NAIC's Accounting Practices and Procedures Manual SSAP No. 67, this liability should contain amounts the company is holding in a fiduciary capacity such as employees' federal tax withholdings. Unallocated cash receipts, such as premium payments received with an application for a new policy, are considered Remittances and Items not Allocated according to the NAIC's Accounting Practices and Procedures Manual SSAP 67. It is recommended that the company comply with the NAIC's Accounting Practices and Procedures Manual SSAP 67 and the NAIC's Annual Statement Instructions – Property and Casualty for the reporting unallocated cash receipts.

Advance Premium Accounting

The examiners reviewed the company's reporting of policyholder advance premium payments. When a policyholder pays an installment in advance of the policy's effective date (e.g. December 2001 installment payment of $100 for a policy with a $400 annual premium and a January 2002 effective date) the company's IT system reports the entire full term premium ($400) as advance premium, and reports the remaining installments ($300) as premium receivable. (The correct accounting is to record only the $100 as advance premium, with no premium receivable until the effective date of the policy.) As a result, the company has overstated both the liability and the asset by the amount of the remaining installments. This accounting treatment had no effect on reported surplus.

According to the NAIC's Accounting Practices and Procedures Manual SSAP 53, "advance premiums result when the policies have been processed, and the premium has been paid prior to the effective date." Pursuant to SSAP 6, premiums are to be recorded on the effective date of the policy, so the company does not have a receivable for the unpaid portion of the premium until the effective date of the policy. It is recommended that the company record only the portion of premium actually received as advance premium in compliance with the NAIC's Accounting Practices and Procedures Manual SSAPs 6 and 53.

The company has begun to work on EDP system modifications to correctly record receipts of advance premiums.

Outstanding Drafts

In order to review and test the outstanding draft liability, the examiners requested that the company provide a detail listing of all outstanding drafts as of December 31, 2001. The examiners found that it is company policy to discard outstanding draft detail after the CPA firm has used it for its audit. However, after further investigation, the company was able to provide a portion of the detail. The detail did not include drafts that were sent back to the bank due to missing endorsements. According to the company, this was due to a programming problem, which was fixed during examination fieldwork.

The situation was similar with the honored draft detail sent by the bank. Company-wide policy is to save the daily reconciliation detail only for the current and prior month. In order to test the completeness of the outstanding draft liability a listing of honored drafts for January 2002 was requested. However since this request was made several months after January 2002, the company was only able to provide this detail for its Midland Region, which happened to save the needed information for the entire year. No detail could be provided for regions where the accounting is done at the home office. Section Ins 6.80 (4), Wis. Adm. Code, requires the insurer to maintain financial records and records of operations for three years. It is recommended that the company comply with s. Ins 6.80 (4), Wis. Adm. Code, for the retention of outstanding and honored draft details.

Affiliated Balances

The company is party to a 100% quota share reinsurance agreement, with the right to offset, with ASIC. The examination noted that the assumed paid losses and loss adjustment expenses (LAE) were being netted with assumed premium written and then flowing through Line 18 "payable to parent, subsidiaries and affiliates" on the annual statement. As a result AFMIC was not reporting any assumed paid losses, LAE, or premium on Schedule F, Part 1 or any reinsurance payable on losses or LAE, or assumed premium receivable on the annual statement. NAIC Annual Statement Instructions – Property and Casualty provides that amounts related to reinsurance transactions should be excluded from "payable to parent, subsidiaries and affiliates" on the annual statement. It is recommended that the company report all affiliated reinsurance transactions on Schedule F and the appropriate lines on the balance sheet as prescribed by the NAIC Annual Statement Instructions – Property and Casualty. It was decided that since this improper treatment by the company has no effect on surplus, determining the amounts involved in the misclassified reinsurance transactions was not necessary. Therefore no reclassification was made.

Subsequent to examination fieldwork the company has reported assumed paid losses and LAE on Schedule F for 2002.

Loss Reserves

In 2002 the company reported a one year reserve deficiency for 2001 of $46.5 million, which was consistent with the findings of our independent actuaries' review. This was the second year in a row that the company reported a one year deficiency and the third time in the past four. The amount is immaterial to surplus; therefore, no adjustment will be made.

The company had higher than expected loss and LAE development in recent years due mainly to two particular lines of business; private passenger auto liability and commercial multiple peril. Auto liability loss experience has been negatively impacted by medical cost inflation, including the higher cost of drug benefits and increasing claim severity. The commercial multiple peril line has been impacted by increasing construction defect claims.

In response to these issues the company has increased the factors used in reserve calculations and made underwriting changes aimed at reducing exposure to construction defect claims, including limiting the size and type of contractors. Changes were also made to the reinsurance program. The company added another layer to the 2002 program, increasing the aggregate limit to $1 billion. Also, AFMIC's retention level was decreased within each layer.

Internal Control

The Electronic Data Processing Specialist reviewed the internal control over the company's computer processing systems. One of the areas of review was control over access to computer systems. The review noted that there was no consistent periodic process where by managers reviewed the access capabilities (read/write) of their databases. It was indicated that this was done for major applications, but for most applications it is up to the manager to initiate the review. The company stated that the largest challenge is consultants, who are not connected to a major application, and it is up to managers to report accounts that should be deactivated. It is recommended that for all significant and/or critical data the company establish a process such that access to the data be reviewed periodically, but no less frequently than annually.

VIII. CONCLUSION

AFMIC is the parent of a holding company system referred to as the "American Family Insurance Group." AFMIC primarily writes automobile and homeowners coverage. The company writes in 22 states, two of which were added in 2002, using an exclusive agency force of about 3,800 agents. The agency system also markets products for ASIC and AFLIC, which were examined concurrently with AFMIC.

The company reported heavy storm related losses in 1998 and 2001. The losses resulted in significantly lower net income than previous years. However, the company did report net income in all years under examination.

The prior examination resulted in three recommendations, of which the company complied with all. The current examination made ten recommendations. Most of the recommendations dealt with reporting issues and of those three had been reported correctly on the 2002 annual statement. There were no adjustments to surplus or reclassification of balance sheet accounts as a result of the examination.

IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 28 - Management and Control — It is recommended that the company continue to maintain compliance with its conflict of interest disclosure requirements for its Board of Directors, officers and designated employees.

2. Page 28 - Management and Control — It is recommended that the company comply with s. Ins 611.56 (1), Wis. Stat. and appoint only directors as members of board appointed committees.

3. Page 29 - Schedule Y — It is recommended that the company report in Schedule Y of its statutory annual statements all transactions among affiliates relating to the cost sharing and income tax allocation agreements in compliance with s. Ins. 40.03 (5), Wis. Stat.

4. Page 29 - Invested Assets — It is recommended that the company amend the custodial agreement to include the language recommended by the NAIC's Financial Condition Examiners Handbook, to replace references to Midwest Securities with the current trust company, and to replace the custodian with the current one.

5. Page 30 - Remittances and Items not Allocated — It is recommended that the company comply with the NAIC's Accounting Practices and Procedures Manual SSAP 67 and the NAIC's Annual Statement Instructions – Property and Casualty for the reporting of Remittances and Items not Allocated.

6. Page 30 - Amounts Withheld or Retained by Company for Account of Others — It is recommended that the company comply with the NAIC's Accounting Practices and Procedures Manual SSAP 67 and the NAIC's Annual Statement Instructions – Property and Casualty for the reporting unallocated cash receipts.

7. Page 31 - Advance Premium Accounting — It is recommended that the company record only the payment portion to advance premium in compliance with the NAIC's Accounting Practices and Procedures Manual SSAPs 6 and 53.

8. Page 32 - Outstanding Drafts — It is recommended that the company comply with s. Ins 6.80 (4), Wis. Adm. Code, for the retention of outstanding and honored draft details.

9. Page 32 - Affiliated Balances — It is recommended that the company report all affiliated reinsurance transactions on Schedule F and the appropriate lines on the balance sheet as prescribed by the NAIC Annual Statement Instructions – Property and Casualty.

10. Page 33 - Internal Control — It is recommended that for all significant and/or critical data the company establish a process such that access to the data be reviewed periodically, but no less frequently than annually.

X. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Name	Title
Andy Fell	Insurance Financial Examiner
Don Gasser	Insurance Financial Examiner
Amy Wolff	Insurance Financial Examiner
John Litweiler	Insurance Financial Examiner
Rebecca Easland	Insurance Financial Examiner
Randy Milquet	EDP Specialist

Respectfully submitted,

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Examiner-in-Charge